Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Poochigian	Analyst:	Roger Lackey	Bill Number:	SB 1974
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	02-25-2000
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Irrigation System Improvements Costs Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a tax credit equal to an unspecified percentage of the cost to purchase and install an irrigation system improvement that provides water conservation or savings and that is used in a business for the production of farm income.

This analysis will not address the bill's sales and use tax provision, as it does not impact the Franchise Tax Board.

EFFECTIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and the credit provisions would apply to taxable or income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 229 (1999/2000), AB 1081 (1997/1998), and SB 1402 (1997/1998) would have allowed a tax credit equal to 15% of the cost to purchase and install qualified water application or distribution equipment that provides water conservation or savings. SB 229 and AB 1081 failed to pass out of the first house by January 31 of the second year, while SB 1402 failed passage in Senate Revenue and Taxation Committee.

PROGRAM HISTORY/BACKGROUND

A similar tax credit for the purchase and installation of water irrigation systems expired on December 31, 1985. That credit, taken in the year of installation, was the lesser of 10% of the cost or a maximum of $500, and was provided in addition to any other qualified deductions.

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Board Position:			Department Director	Date
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Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business. Expenses related to water conservation qualify to the extent that they are ordinary and necessary business expenses and are not for the purchase of property with a useful life of more than one year.

Existing state and federal laws allow taxpayers to use various credits against tax. Neither state nor federal laws currently have a tax credit similar to the one proposed by this bill.

This bill would allow taxpayers that own or lease agricultural land to claim a tax credit equal to an unspecified percentage of costs paid or incurred for purchasing and installing an irrigation system improvement.

This bill would extensively define the term "irrigation system improvement" in terms of the types of qualifying equipment and the impact on water use. Also, this definition would specify that a physical improvement, an alteration, or an addition of equipment would be an "irrigation system improvement" if it is certified to meet the bill's criteria. Certification must be given by a registered civil engineer, registered agricultural engineer, or certified irrigation designer who is independent of the taxpayer and the seller or provider of the physical improvement, alteration, or equipment.

Any excess credit could be carried over indefinitely. However, any unused carryover credit in the next year or subsequent years would be disallowed if the taxpayer sells the land on which the qualified equipment was installed.

The basis of the qualified equipment would be reduced by the amount of the allowable credit.

Policy Considerations

Because this bill requires an adjustment to basis, it would create a state and federal difference, thus increasing the complexity of tax return preparation. However, disallowing the adjustment would mean that the taxpayer would receive a double tax benefit with respect to the same expenses.

The credit recapture provision of this bill would provide disparate treatment to taxpayers depending upon their status as a landowner or a lessee of farmland. For example, this bill would eliminate the credit carryover of an owner/taxpayer who purchases qualified water application equipment and then sells the land on which the qualified water application equipment had been installed. Conversely, it would allow a credit carryover to a taxpayer who leases the same land and terminates the lease after incurring the costs qualifying for this credit, even if the qualified water application equipment is removed from the leased property. Moreover, an owner/taxpayer who is able to fully utilize the credit against the tax or net tax in the year of installation would suffer no recapture penalty should the property be sold the following year.

This bill does not specify a repeal date or a limit on carryovers. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. Recent credits have been enacted with a carryover limit since experience shows credits are typically used within eight years of being earned.

Implementation Considerations

The requirement that the certifying engineer or designer be "independent of" the taxpayer is a subjective standard and may be open to interpretation. Providing an objective relationship standard, perhaps by reference to an existing tax law standard defining a "related party," would make it clear that the engineer or designer may not be an employee or otherwise related to the purchaser, seller or manufacturer of the water application or distribution equipment.

The use of a water application or distribution system on fallow land would be an increase in the amount of water used on the land, and as a result the installation of "irrigation system improvements" on such land would not meet the specified requirements of the bill and may not be considered eligible for the credit.

Technical Considerations

The recapture provision under the B&CTL uses the term "taxable years." Amendment 1 would correct the reference to "income years."

FISCAL IMPACT

Departmental Costs

If the implementation concerns are resolved, this bill is not expected to result in significant costs to the department.

Tax Revenue Estimate

The revenue analysis is estimated to impact PIT and B&CT revenue as shown in the following table (A 15% tax credit is assumed):

Revenue Impact of SB 1974 Income/Taxable Years Beginning After 1/1/2000 Enactment Assumed After June 30, 2000 $ Millions			
	2000-1	2001-2	2002-3
Revenue Impact	($8)	($12)	($15)

This analysis assumes that the installation must take place in California. Any changes in employment, personal income, or gross state product that could result from this measure are not considered.

Tax Revenue Discussion

This estimate was developed in several steps. Based on discussions with industry experts, it was assumed that at replacement of existing systems, plus the install of new systems as a result of this bill, would mean that about 200,000 acres of irrigated land in California would adopt water-saving systems or equipment. The average cost per acre to install the equipment and improve the irrigation system was calculated at about $525 per acre for 2000.

The total qualifying expenditures were calculated and a 15% credit was assumed to arrive at the total qualified credit amounts, which are projected to be on the order of $200 million for 2000. The applied credit amounts were adjusted to account for the reduction in depreciation that would result from the use of the credits. The portion of credits that could be applied in any given year was estimated using tax returns that report farm income. It was assumed that unapplied carryover credits would be exhausted by the fourth year.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1974
As Introduced February 25, 2000

AMENDMENT 1

On page 6, line 27, strikeout "taxable years" and insert:

income years